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**International
Economic & Energy
Weekly**

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22 November 1985

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**International
Economic & Energy Weekly**

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22 November 1985

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**International
Economic & Energy Weekly**

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The Soviets' use of the US economy as the standard against which to measure their own progress is longstanding, but the Soviets' own statistics show that they have made no progress in overtaking the US economy since the mid-1970s.

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19 Central American Core Four: Struggle for Economic Recovery

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Although expanded US aid to the Core Four—Guatemala, Honduras, Costa Rica, and El Salvador—is providing a much needed economic boost, few signs of internally generated strength have been exhibited as these countries struggle to emerge from their worst recession on record. The social pressures engendered by ongoing economic stagnation will compound the other problems confronting the region's emerging democracies.

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**International
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Perspective***Western Europe's Conservative Socialists***

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Many West European governments have rejected traditionally socialist policies—redistributing income from the well off to the less prosperous, expanding the welfare state, and increasing government intervention in the economy—as concern over Western Europe's lackluster economic performance has grown. The consensus that West European socialist parties created in the 1960s on economic policy has faded. A Socialist-led government is no longer synonymous with traditional socialist policies. Accelerating inflation and growing foreign payments problems forced France in 1982 and Greece last month to shift from stimulative economic programs to austerity. Socialist-led governments in Spain, Portugal, and Italy from the beginning put policies in place that were even more conservative than those of the center-right governments they replaced.

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Public confidence in socialist prescriptions for Western Europe's economic ills—often adopted by nominally right-of-center governments—was shaken by the failure to revive vigorous growth after the oil price shocks of the 1970s. The failure of the original Mitterrand economic program solidified the current consensus among West European governments that reducing inflation and cutting budget and current account deficits are the only sure ways of restoring the region's economic health. The Spanish Socialists, who dropped Marxism as their official philosophy a couple of years earlier, especially took the French experience to heart. Since taking office in 1983, the thrust of the Gonzalez government's policies has been almost indistinguishable from that of the Kohl government in West Germany; indeed, Gonzalez never used the word "socialism" in this year's economic debate in parliament.

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Austerity has been painful, however. In most West European countries, unemployment has increased steadily for 10 years. Although government agreement on austerity remains nearly universal, public support may be weakening. According to recent polls, Prime Minister Thatcher's approach to economics is wearing thin with the electorate, which now gives as much support to the Labor Party and the Social Democratic/Liberal Alliance. Although the Conservatives could recover—especially if unemployment falls from its current 13-percent level—a close three-way election in 1987 or 1988 could result in a Labor majority. In West Germany, the politically weak performance of Chancellor Kohl could allow the Social Democrats (SDP), now in disarray, to recapture the national government. Although the SDP leadership is moderate, the rambunctious left wing of the party could prove influential.

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If the socialist parties dominate new governments in London and Bonn, Washington could lose important allies in efforts to liberalize trade and financial flows. In an era of slow economic growth, socialist governments in the late 1980s would focus on bringing down unemployment, not creating a "fairer" distribution of income. They almost certainly would adopt expansionary fiscal and monetary policies and would be tempted to erect new trade barriers to protect jobs in import-competing industries. Moreover, capital controls would appeal to them as a way to keep investment funds at home. Even center-right governments could come under pressure to adopt similar policies to ease unemployment.

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Greece: Shift to Austerity

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Prime Minister Papandreou's recent austerity measures are aimed at curbing a soaring current account deficit, cutting the huge public-sector deficit, and reducing high levels of inflation. Although the moves have sparked widespread labor protests over cuts in real wages, Papandreou appears to be hanging tough. The new policies should improve the foreign payments position—saving Papandreou the embarrassment of seeking IMF assistance—but they fail to address most of the country's domestic economic problems. To revive private investment and improve Greece's competitiveness over the longer term, Papandreou will need to liberalize the heavily state-dominated economy. There are few indications, however, that he intends to tackle these more difficult issues.

The Deteriorating Economy

Greece began to experience serious economic problems in 1979, and since then GDP growth has averaged only 1 percent annually. Over the same period, private investment fell sharply and inflation remained in the 20-percent range. Unemployment meanwhile has topped 8 percent—quadruple the 1979 rate—and is still rising.

Of more immediate concern is the deterioration in the foreign payments position. Greece traditionally has run a current account deficit equivalent to 3 to 4 percent of GDP, covering most of this imbalance with private capital inflows. During 1979-84, however, this share has averaged 5.6 percent of GDP. In the first seven months of this year, it soared 54 percent above the year-earlier period and is likely to reach about 9 percent of GDP for all of 1985.

The worsening current account deficit has pushed Greece's external debt from \$10 billion in 1981 to an expected \$16 billion in 1985, while the debt service ratio has risen from 17 percent to about 25

percent. While Athens has not yet encountered serious debt service problems, the IMF in April projected a debt crisis later in the decade—unless the current account deficit improved quickly—because debt service is scheduled to rise rapidly after 1985 as grace periods on loans expire.

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The Causes

While some of Greece's economic problems are attributable to the 1979 oil price shock, we believe the primary responsibility lies with the policies of Papandreou and his predecessor. Belying its conservative label, the previous New Democracy regime went on a spending binge during its last two years in office, pushing the public-sector deficit from 6.3 percent of GDP in 1979 to 14 percent in 1981. It also attempted to restrain import prices by holding up the value of the drachma—which in turn worsened Greece's international competitive position. Finally, the conservatives stepped up government intervention in the economy, including the imposition of price controls and restrictions on layoffs.

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Pushed by his own ideology and by the strong leftwing of his Pan-Hellenic Socialist Party (PASOK), Papandreou during his first term made the economic situation even worse. He quickly raised the minimum wage by 50 percent and introduced wage indexation. In addition, he further increased direct government intervention in the economy, including more labor market restrictions, state takeovers of a number of firms, controls on imports and on importers' profits, and establishment of state foreign trade organizations. Finally, the government's antibusiness rhetoric further reduced the incentive for both domestic and foreign firms to invest in the Greek economy.

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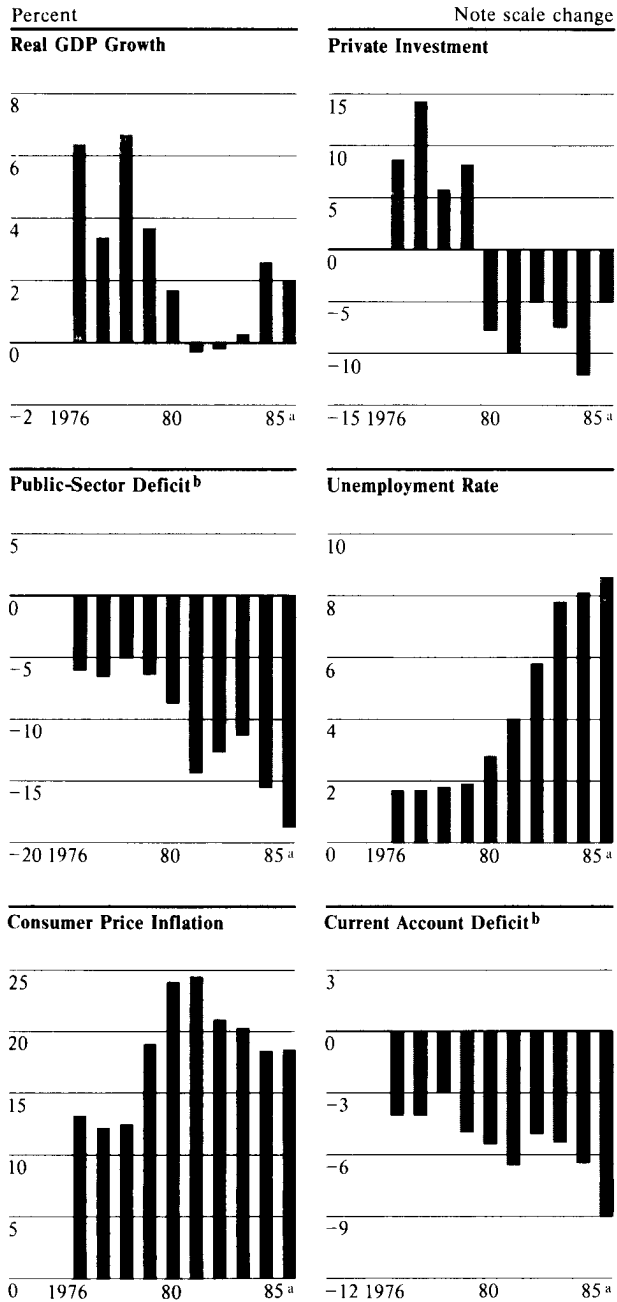
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Greece: Economic Indicators, 1976-85



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On the positive side, Papandreou did reduce the overvaluation of the drachma, raised some interest rates to more realistic levels, and initially succeeded in reducing the public-sector deficit by boosting taxes. In anticipation of the June 1985 election, however, all attempts at fiscal restraint ceased: the public-sector deficit apparently will approach 19 percent of GDP this year.

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Shift To Austerity

Faced with the embarrassing possibility of being forced to seek IMF assistance, Papandreou announced a number of austerity measures last month including:

- Devaluing the drachma 15 percent.
 - Requiring substantial advance deposits on imports.
 - Reducing the real incomes of workers through an adjustment in the wage-indexation formula.
 - Cutting public spending, coupled with stricter enforcement measures against tax evasion, and a one-year tax surcharge on profits and incomes of the self-employed.
 - Eliminating some preferential lending rates.
- In addition, Athens petitioned the EC for permission to delay implementing certain measures required under the EC accession treaty, such as dismantling the state petroleum monopoly, ending tax rebates on exports, lifting restrictions on capital movements, and introducing a value-added tax.

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We believe that Papandreou's abrupt policy shift means that he finally recognizes the seriousness of Greece's economic problems. In public and private comments, he has said that Greece no longer can afford to spend more than it produces. Moreover, he probably felt he was in a strong position politically to implement a tougher economic policy following his decisive reelection victory in June. Papandreou also may have been trying to pave the way for a \$1.5 billion balance-of-payments loan just received from the EC.

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Greece: Current Account Balance, 1979-85

Million US \$

	1979	1980	1981	1982	1983	1984	1985 ^a
Current account balance ^b	-1,882	-2,216	-2,421	-1,885	-1,876	-2,182	-2,950
Trade balance	-6,178	-6,809	-6,697	-5,927	-5,386	-5,379	-6,250
Exports	3,932	4,094	4,771	4,141	4,105	4,400	4,250
Imports	-10,110	-10,903	-11,468	-10,068	-9,491	-9,779	-10,500
Services and transfers balance	4,296	4,593	4,276	4,042	3,510	3,197	3,300
Tourism	1,360	1,424	1,520	1,153	814	978	1,220
Shipping	1,312	1,550	1,455	1,396	1,079	928	800
Emigrant remittances	1,165	1,080	1,076	1,039	931	903	880
Interest and dividends	-158	-267	-589	-647	-793	-944	-1,100
EC subsidies	0	0	148	550	834	715	900
Other	617	806	666	551	645	617	600

^a Estimated.^b Settlements basis.**Economic Outlook**

With these measures in place, Papandreu most likely will be able to avoid turning to the IMF for assistance—a move that we believe otherwise would have been necessary within about two years. The EC loan probably will allow Greece to avoid becoming the first EC country to reschedule its debt. To get the loan approved, however, Athens has had to agree to some tough conditions, including tight monitoring of the Greek economic program before the second tranche of the loan is released.

If Papandreu's program is fully implemented, our econometric analysis indicates a dramatic improvement in the current account balance. This scenario assumes that the 15-percent devaluation is maintained in real terms and that real wages are cut by 15 percent over the next three years. In this case, the current account deficit would shrink to an easily manageable \$1 billion in 1988—\$2.4 billion less than in the baseline scenario, which assumes no change in policy.

Even in the more likely case where Papandreu backslides on the harsher elements of his program, the foreign payments position could still improve significantly. Assuming the government maintains a real devaluation of 10 percent and achieves a 5-percent decline in real wages, we estimate the current account deficit would be reduced by \$340 million in 1986, \$1 billion in 1987, and \$1.5 billion in 1988, compared with the baseline scenario. While the 1988 deficit of \$1.9 billion would still be uncomfortably large, the improving trend probably would enable Athens to finance it from a combination of EC and private sources.

On the domestic side, GDP growth is likely to slow significantly next year, despite an increase in exports, because of lower public and private consumption and continued strike activity. Unemployment probably will edge up because of slower economic growth and the continued financial difficulties of many private-sector firms. Moreover, inflation is

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likely to rise initially because of the devaluation, reaching the 20- to 22-percent range for 1986.

[REDACTED]

In the longer run, we believe stronger measures are needed to correct Greece's domestic problems. This would require a liberalization of the state-dominated economy, including:

- Lifting price controls.
- Reducing the public-sector work force.
- Expanding the tax base to include farmers.
- Raising interest rates.
- Reducing government regulation in the labor market and elsewhere.

[REDACTED]

We believe Papandreou is unlikely to tackle these more difficult economic problems because he almost certainly would encounter fierce opposition from the very groups that brought him to power. National Economy Minister Simitis recently said that additional measures were unnecessary to reach the government's economic targets, although some actions would be taken to encourage private investment. Simitis ruled out any changes in Athens's system of price and labor controls, or any increases in taxes on farmers and workers.

[REDACTED]

As a result, the long-term outlook for the Greek economy is poor. Greece probably will continue to suffer from low rates of private investment and an inefficient allocation of resources due to the market distortions created by pervasive government controls. The inefficiency of Greek industry will hamper its ability to compete with the rest of Western Europe at a time when private firms will be facing increased competition as called for under the terms of Greece's EC accession treaty. As a result, Greece may feel compelled to further delay fully implementing the treaty.

[REDACTED]

Political Implications

Papandreou probably is facing a long battle with labor over economic policy, and a flurry of large strikes have already occurred since the austerity

measures were announced. A worsening economic situation would pose an obstacle to his reelection prospects provided the opposition gets its house in order before the 1989 deadline for holding elections. Even with the likely continuation of labor strife, Papandreou appears to be hanging tough on his present policy stance and is unlikely to face a serious challenge to his leadership of PASOK. He has presented his policies as the only alternative to seeking IMF assistance and has accused his Communist and conservative opponents of forming a common front to destabilize the political situation. Nonetheless, the unavoidable shift to more conservative policies will be anathema to many of the government's supporters. Moreover, in contrast with the situation during Papandreou's first term, these groups probably will see little or no material gains over the next four years.

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**Nicaragua:
Agricultural Outlook
Deteriorating**

Nicaragua's already dismal agricultural performance of the past few years promises to become even worse during the current November-March harvest. Government officials estimate that agricultural export earnings this year will fall to only \$250 million—some \$100 million below the 1984 level and a drop of 50 percent since the Sandinistas came to power—and the decline probably will deepen next year. While the insurgency has forced the government to divert some resources from the agricultural sector, ineffective Sandinista policies are largely to blame. The regime's tentative steps to improve incentives are unlikely to reverse the trend.

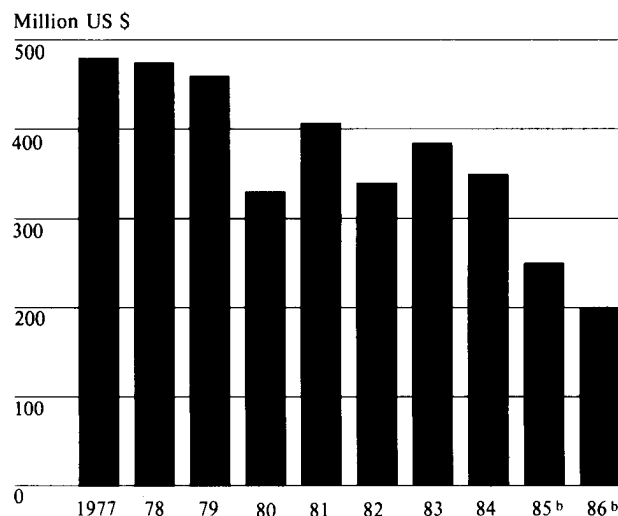
Outlook for Coming Harvest

Economic planners fear the harvest will yield as little as \$200 million in export earnings next year. Agricultural exports account for 80 to 90 percent of total exports each year. While some minor crops may meet or surpass last year's levels, most crops will probably miss by wide margins.

Cotton brought in \$100 million this year but will decline sharply in 1986—perhaps by more than half. According to US Embassy officials, private growers substantially reduced plantings because of government price and credit controls. Moreover, a virulent disease now infests much of the crop. According to press reports, Agriculture Minister Wheelock recently admitted the government could have prevented 90 percent of the infestation if it had followed recommendations to treat the seeds with chemicals before planting. Another agricultural official says income from cotton next season may just cover production costs, according to the US Embassy.

The upcoming coffee harvest will be plagued by many of the same problems of the last season—price disincentives, shortages of skilled pickers, and

**Nicaragua: Agricultural Exports,
1977-86^a**



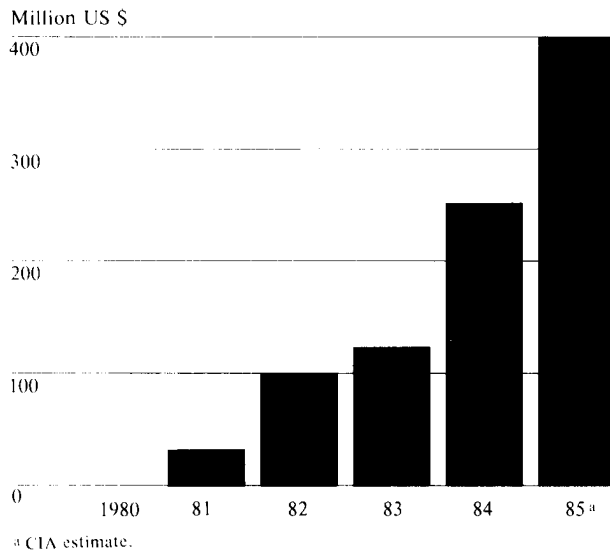
^a Represents exports largely from harvest ending March of each year.
^b Estimated.

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inadequate transportation. According to US Embassy officials, overall yield is likely to drop further from its 1984 level, and Nicaragua will probably not be able to produce enough beans of export quality to fill its International Coffee Organization quota.

Prospects for other crops are equally bleak. According to the US Embassy, an agricultural official says Managua is losing money on every pound of sugar produced. Nicaragua will have to increase imports of grain because drought, manpower shortages, and low producer prices have sharply reduced projected yields of corn, beans, and rice.

Nicaragua: Nonmilitary Imports From the Soviet Bloc, 1980-85



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Causes

Managua's response to increased insurgent activities—especially its diversion of 50 percent of the budget to military spending—has contributed to the recent agricultural decline. Many farm workers have left the fields to join the insurgents, and others have been drafted. Anti-Sandinista insurgents have sought to destroy pesticides, fertilizer, machinery, and transportation equipment belonging to state farms which has reduced plantings and further lowered productivity. Although Managua blames US policies for the drop in output, the insurgency has only disrupted a small portion of agricultural activity.

Government economic policies and mismanagement are the major reasons for the decline. The increase in expropriations of land and crops over the last year has demoralized private farmers, according to the US Embassy. Many of them are in critical financial straits, and some—notably cotton

growers—may be bankrupted by poor harvests this year.

state farms and cooperatives—which consume the bulk of the government's financial resources—have a loan default rate of over 70 percent and productivity rates well below those of private farmers.

Prospects

The Sandinistas are taking steps to improve price incentives, secure adequate labor, overcome logistical problems, and obtain needed inputs:

- The regime recently announced that producers will receive partial payment in dollars for some crops and has increased wages for harvest labor, according to US Embassy reporting.
- Managua again is organizing international volunteers and mobilizing students, teachers, and armed soldiers to pick crops.
- Embassy reporting indicates Nicaragua plans to import 500 trucks from Japan and the Soviet Bloc to bring in the harvest.
- The government claims to have found new sources of pesticides in Western Europe and the Soviet Bloc.

Such measures have been inadequate to halt the deterioration of Nicaraguan agriculture, however, and the Sandinistas probably will become even more dependent on Soviet Bloc assistance to avert serious food shortages.

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Gulf Cooperation Council: Pushing Petrochemicals

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Saudi attempts to find markets for its expanding petrochemical exports have generated trade frictions with the EC, Japan, and the United States. The Gulf Cooperation Council¹ (GCC)—led by Saudi Arabia—is seeking to negotiate trade agreements to gain increased access for its petrochemical production, in which it has invested billions of dollars, but so far has received no firm commitments. Riyadh is attempting to play off these developed country importers against one another, betting that neither the EC, Japan, nor the United States will want to risk losing access to the important Gulf regional market for their exports. If growing protectionist pressure leads to the erection of further trade barriers against Gulf petrochemicals, Saudi Arabia would impose retaliatory tariffs.

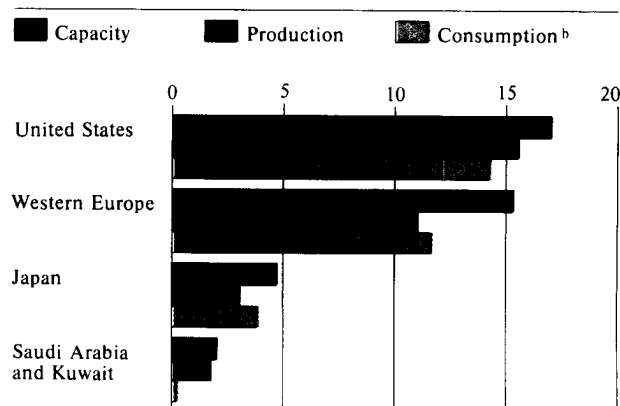
Problems in a Glutted Market

Saudi Arabia and Kuwait began developing their petrochemical industries in the oil boom years of the 1970s. Saudi Arabia has spent at least \$14 billion to establish two major petrochemical complexes. These capital-intensive facilities enjoy major economies of scale because of their efficient design, colocation with other petroleum activities, and cheap natural gas feedstock—approximately one-sixth the price of natural gas in Western Europe and North America.

The petrochemical market has changed, however, since these projects were first conceived, and completed plants face a glutted market. Still, Riyadh has continued to give high priority to these projects, especially since 1982 when oil revenues began to fall, and the Saudis became even more determined to diversify from their dependence on crude oil exports.

¹ The GCC comprises Saudi Arabia, Kuwait, Qatar, Bahrain, the United Arab Emirates, and Oman.

Selected Ethylene Producers, 1985^a



^a Estimated. The 1985 estimate of ethylene capacity, production, and consumption assumes full operation of all the ethylene plants in Saudi Arabia and Kuwait now completing construction (Safal, Yanpet, Petrokemya, and Shuaybah). Some plants might not actually be in full operation until 1986.

^b Consumption in ethylene derivations.

Although the US, Japanese, and Korean partners of the Gulf petrochemical producers enjoy the advantage of access to low-cost Saudi output, other producers in the United States, EC, and Japan complain that they are being squeezed by Middle Eastern producers who have an unfair cost advantage. The Saudis argue, however, that production cutbacks in the West will benefit all because inefficiencies in the world petrochemical market result in increased costs to final petrochemical consumers. They maintain that high-cost producers should concentrate on higher value-added specialty petrochemical products. They claim they have no unfair cost advantage because Saudi Arabia has

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Petrochemical Plants in Saudi Arabia and Kuwait

	Foreign Partner(s)	Location	Completion Date	Estimated Cost (billion US \$)	Annual Production Capacity (1,000 metric tons)
Saudi Arabia					
Al-Jubail Petrochemical Company	Exxon	Jubail	1985	1.3	260
National Methanol Company	Celanese, Texas Eastern	Jubail	Partly onstream	0.4	650
Arabian Petrochemical Company		Jubail	1985	1.5	500
Saudi Arabian Basic Industries Corporation	Agip, Neste Oy	Jubail	1985	0.4	254
		Jubail	1986	NA	500
Saudi Petrochemical Company	Shell	Jubail	1985	2.8	2,060
Saudi Arabian Fertilizer Company		Dammam	Onstream	0.3	450
Al-Jubail Fertilizer Company	Taiwan Fertilizer	Jubail	Onstream	0.4	500
Eastern Petrochemical Company	Japanese consortium	Jubail	1985	1.5	130
Saudi Methanol Company	Japanese consortium	Jubail	Onstream	0.3	600
Saudi Yanbu Petrochemical Company	Mobil	Yanbu	1986	2.5	510
Kuwait					
Petrochemical Industries of Kuwait		Shuaybah	1985	NA	350

other costs—construction with imported materials, transportation, high-salaried expatriate workers, and expensive training programs for nationals—that are considerably higher than those of their competitors.

EC-GCC Trade Friction

EC petrochemical producers are becoming increasingly concerned about the prospect of a flood of low-cost Saudi petrochemicals entering their markets. In recent years, the Europeans have closed over 20 petrochemical plants and laid off 70,000 workers, compounding their already worrisome unemployment problem. The situation worsened last year when the Saudis began to cut petrochemical prices to gain a larger market share and circumvent OPEC price guidelines, which do not cover petroleum products.

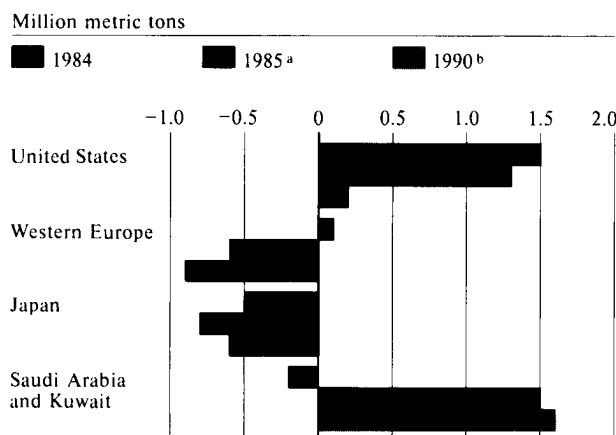
In June 1984, responding to growing protectionist pressure, the EC imposed a 13.4 percent tariff on Saudi methanol exports, straining EC-GCC relations. Earlier that year, the Saudis had exceeded the very small duty-free import limit allowed under the EC's Generalized System of Preferences (GSP). They requested tariff exemption, but the Community claimed that the industry had strategic importance and needed protection while it was restructuring. The Saudis continued to press the EC to abandon the duty or to raise its duty-free quotas, and their refusal prompted the GCC to threaten retaliatory tariffs on European exports to the Gulf—the EC's third-largest export market.

Tensions between the EC and the GCC eased somewhat following trade talks in Bahrain last March, despite vast differences in their negotiating

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Selected Countries Trade Balances in Ethylene Derivatives, 1984, 1985, and 1990



^a Estimated.
^b Projected.

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positions. Gulf officials advocated a two-phase agreement: the first to guarantee preferential access for their petrochemical and petroleum product exports, and the second to include broad discussions on trade. The Europeans, however, refused to commit themselves to the GCC agenda and saw the talks as purely exploratory.

In August, the EC imposed a 14-percent tariff on imports of Saudi polyethylene. The duty surprised Saudi officials because polyethylene imports from the kingdom equaled only 1 percent of total polyethylene production in the EC. Saudi officials told EC Commissioner Cheysson that they opposed the erection of trade barriers and that they considered the tariffs a blow to Saudi prestige, according to the US Embassy in Riyadh.

Meanwhile,

in an attempt to conciliate the Saudis, the EC Commission advocated increased duty-free ceilings for all key Gulf petrochemical exports.

Despite their anger at the imposition of the new tariff, the Gulf Council has continued to push for an accord with the EC and a ministerial meeting was held with Community leaders in Luxembourg on 14 October. The parties reached an interim agreement—to last through 1986—under which the EC agreed to advise the GCC when tariff action on a GCC export was imminent. GCC officials believe, however, that they will receive only the shortest possible notice to preempt a flood of GCC products into the EC just prior to the imposition of duties, according to the US Embassy in Riyadh.

Talks With the United States and Japan

The GCC began to press for exploratory economic talks with the United States last March, probably as a result of disappointment over progress in their talks with the Europeans and fear of growing US protectionist pressures. In September, the GCC proposed an agenda for a first round of talks in December that would include trade and market access, energy—excluding pricing and production levels—investments and financial safeguards, and technology transfer and industrial cooperation. The Council hopes to encourage transfer of technology through joint ventures and enhance investment opportunities in the United States.

Council members expect that the preliminary talks will result in an overall trade agreement, according to one of the GCC negotiators. Some GCC officials have pushed for negotiation of a free trade area, similar to that arranged with Israel earlier this year, saying that the GCC seeks equitable treatment.

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GCC talks with the Japanese are still in the preliminary stages. The Gulf Council first proposed exploratory trade talks last July. Tokyo was reluctant to agree, however, because it fears that the GCC would view the talks as a preamble to negotiations for some kind of bilateral agreement similar to that proposed with the EC—Japan prefers to conduct trade negotiations under the GATT. Nonetheless, the Japanese petrochemical industry is showing some willingness to reduce domestic production to accommodate more imports from the GCC and the United States, according to the US Embassy in Tokyo. []

The GCC has continued to push for talks, despite Japanese reluctance. In September, GCC Secretary General Bishara visited Japan to discuss future economic negotiations. His presentation was not well received, however, and the visit reportedly set the talks back several months when Bishara mistakenly referred to the possibility of a formal agreement, upsetting the Japanese. []

Saudi Arabia as Motivator

The Saudis need access to Western markets for their rapidly expanding petrochemical industry. Riyadh has tried to negotiate for such access bilaterally with its major trading partners but failed when the EC began imposing duties on its petrochemical exports. Riyadh now worries that protectionist sentiment in the United States and Japan will cause them to follow suit. []

Saudi Arabia is trying to use the GCC to strengthen its negotiating position and to protect its national interest, much in the way it used OPEC in the past. Chief GCC negotiator Quwais—who is also a Saudi economic official—claims the Gulf states seek to negotiate together to protect common interests. In fact, the smaller states are unlikely to play much of a role and are content to sit back and let the Saudis take the lead on trying to hammer out trade agreements. []

Outlook

The GCC states—particularly Saudi Arabia—will continue to aggressively market their petrochemical products and will press for trade agreements using the threat of retaliatory tariffs in a carrot and stick approach to gain increased market access. They probably believe that the United States, the EC, and Japan have few alternatives to negotiating and that each wishes to avoid falling out of favor with the Gulf Council and possibly losing access to a lucrative export market. []

Tensions between Western petrochemical producers probably will increase. The EC is likely to push the United States and Japan to share the burden of additional imports of Gulf petrochemicals, which they believe they will be forced to accommodate. It will call for talks with all producers to attempt to secure market stability. EC officials predict that 50 million metric tons of refined oil products will come into the world market from the Gulf region by 1990 and that they can only absorb 20 million tons of this total. If Japan and the United States cannot take the other 30 million tons and refuse to reduce existing tariffs, the EC will be pressed to increase its tariffs as well. []

Implications for the United States

An economic dialogue with the Council offers the United States potential commercial advantages—including preferential access to the Gulf regional market. An economic agreement would also serve as an important political gesture to Council members. For its part, Riyadh will continue to cite the importance of the petrochemical industry to the kingdom and stress the need to maintain good Saudi-US relations. Riyadh is particularly sensitive to its growing trade deficit with the United States—nearly \$2 billion last year. If trade talks

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falter or if US protectionist pressure grows, however, the Saudis will threaten and probably will carry through with retaliatory measures—through the Gulf Council—to try to defend its interests in the US market.

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A Comparison of the US and Soviet Economies

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The Soviets' use of the US economy as the standard against which to measure their own progress is longstanding. General Secretary Gorbachev reportedly wants to make good on Khrushchev's boast that the USSR would surpass the United States economically and industrially. But the Soviets' own statistics show that they have made no progress in overtaking the US economy since the mid-1970s. More detailed comparisons based on Western measures present a similar picture and show how far Gorbachev has to go.

States disengaged from the Vietnam conflict; the share of GNP going to defense fell from 10 percent in the late 1960s to 5 percent in the mid-1970s. During approximately the same period, consistent growth pushed total Soviet defense costs to a peak about 40 percent higher than those of the United States. The annual rate of Soviet defense growth slowed after 1976 but slower economic growth kept the share of GNP going to defense at 12 to 13 percent. With the acceleration in US defense spending, the gap has closed markedly, but the cumulative costs of Soviet defense activities between 1976 and 1983 still exceeded those of comparable US activities by about 30 percent.

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Sizing Up the Soviet Economy

GNP. The gap between the Soviet and US economies narrowed between 1960 and 1975, as Soviet GNP rose from 49 to 57 percent of the US total.² The USSR lost ground after that, however, as its GNP fell to 52 percent of US GNP by 1984. Viewed in another way, Soviet GNP in 1984 was about as large as US GNP was 20 years earlier. Through the 1960s and up to the mid-1970s, Soviet real growth rates were higher, on average, than US rates. The pattern shifted in favor of the United States between 1976 and 1984, when Soviet average GNP growth was less than that of the United States.

Investment. Since 1960 the USSR has devoted a greater share of its economic resources to investment than has the United States. In the USSR, investment climbed steadily from 20 percent of GNP in the early 1960s to 28 percent by 1983, while in the United States it fluctuated between 17 and 20 percent. Total Soviet investment in buildings, structures, machinery and equipment, and selected aspects of capital repair grew almost twice as fast as that of the United States during 1960-83; it averaged 5.5 percent annually, while that of the United States averaged 3 percent.

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Defense. The Soviet Union committed substantially more resources to defense activities than did the United States over the last decade. The Soviets procured more weapons of almost every type, operated larger forces, and pursued a greater research and development effort. US defense spending declined in real terms during 1969-76 as the United

The Soviets have not gotten as much from these high levels of investment as one might expect. Productivity began declining absolutely in the mid-1970s and appears to have stabilized at a level of no growth in the last few years. The physical condition of industrial facilities holds down productivity, and construction delays have hindered the expansion and modernization of plant and equipment. Equipment shortages and transportation bottlenecks—occurring with increasing frequency and intensity—have aggravated the construction delays. In

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² To compare two economies, each country's goods and services are priced in the other's currency. The "average" is the geometric mean of the comparisons in dollars and rubles.

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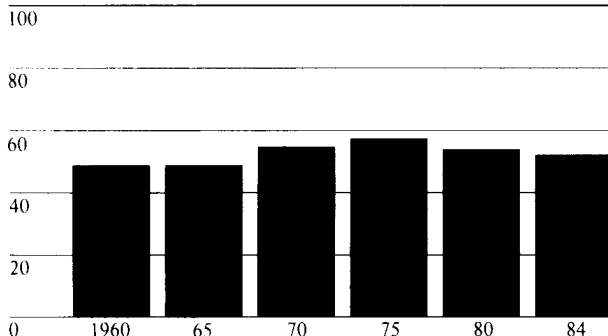
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USSR-US: Gross National Product Comparisons, 1960-84

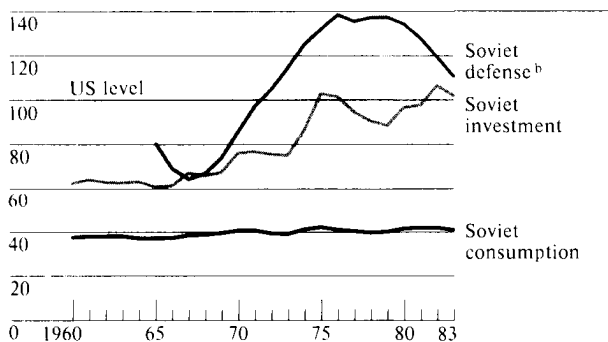
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Soviet GNP^a, Selected Years
Percentage of US GNP



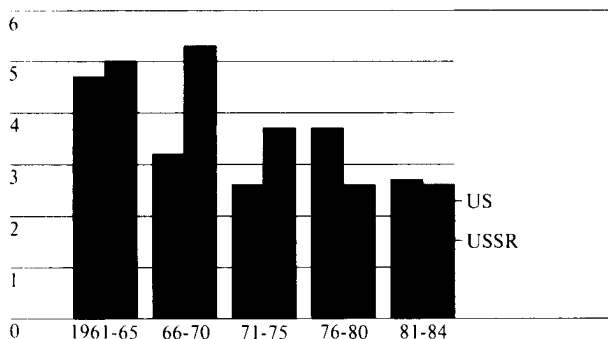
Components of GNP, 1960-83^a

Soviet as a percentage of US



Average Annual Growth of GNP, 1961-84^c

Percent

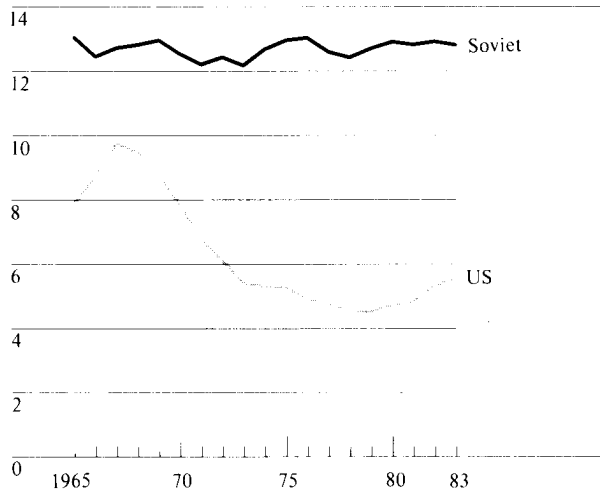
^a The Soviet level is the geometric mean of the dollar and ruble comparisons.^b The defense comparison begins in 1965 because we are less confident in our estimates for 1960-64.^c Both GNPs are measured in own prices. The base years for these periods are 1960, 1965, 1970, 1975, and 1980.

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USSR-US: Defense Burdens^a, 1965-83

Percent of GNP

^a US data are in 1976 dollars; Soviet data are in 1970 rubles.

Note: Burden estimates are based on a US definition of defense.

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addition, capital is used inefficiently—Soviet enterprises continue to use obsolete equipment that requires frequent, costly, and labor-intensive repairs.

Aware of these problems, Gorbachev has made raising productivity and efficiency primary goals of his new economic agenda. He is reallocating investment resources toward modernizing capital stock, replacing inefficient managers with more dynamic ones, and renewing Andropov's anticorruption and discipline campaigns.

Consumption. The Soviets have gained slightly on the United States in total consumption since 1960. Their consumption over the period rose from 37 percent of the US level in 1960 to 41 percent in 1983. Gorbachev has recognized the need to pay more attention to the consumer. The new Party program promises to double the volume of resources devoted to the consumer sector by "as early as" 2000.

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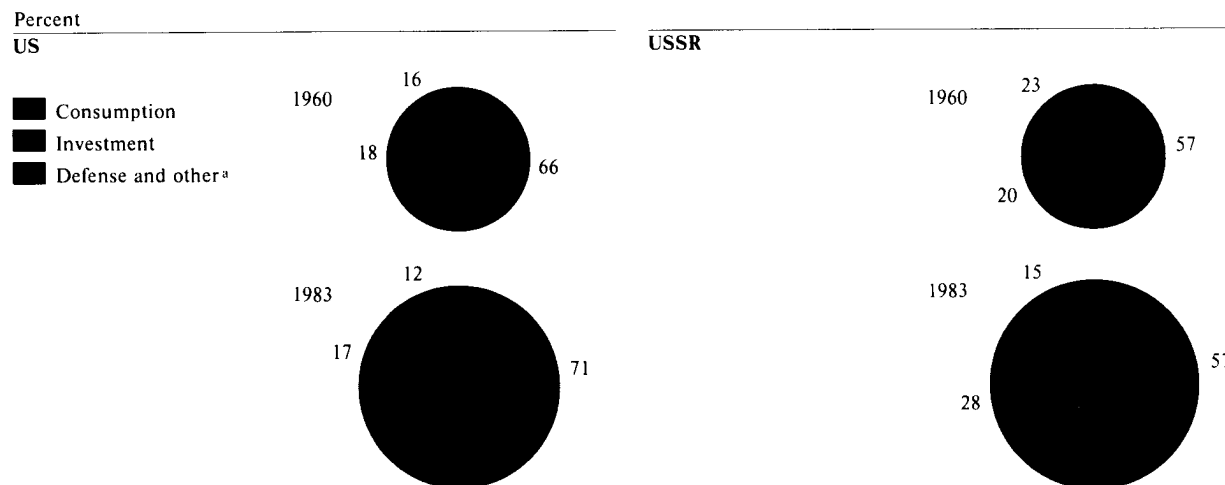
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USSR-US: Consumption and Investment as Shares of GNP, 1960 and 1983



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Consumption accounts for a much larger portion of GNP in the United States than it does in the Soviet Union—71 and 57 percent, respectively, in 1983. Within the consumption category, the US economy has increasingly shifted toward the provision of services—the Soviet service sector remained at a relatively steady 12 percent of GNP over the last two decades, while the US service sector increased from 34 to 39 percent of GNP by 1983.

But What About the Little Guy?

The comparisons presented so far are useful but they do not tell us how well each country provides for its people. The USSR's per capita consumption level is like that of a country with a much lower per capita GNP and has a long way to travel before it can match levels in Western countries. Its per capita consumption expenditures—widely acknowledged as an indicator of standard of living—are only about one-third those in the United States. In

addition, the poor quality and limited availability of many Soviet consumer goods and services are persistent torments of daily life:

- Health care is notoriously bad: insufficient funding, lack of qualified personnel, and shortages of supplies have helped make the USSR the only major industrial nation in which life expectancy is lower now than it was 20 years ago.
- Housing is shoddily constructed and poorly maintained, and about 20 percent of the urban population either lives in dormitories or shares living space with unrelated families and singles. In addition, most newlyweds are forced to live with their families because the waiting period for a new apartment may be as long as a decade. On average, Soviet citizens have less than one-third of the general housing space per capita in the United States.

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- Soviet consumer goods are usually of lower quality than Western models. The lack of quality control and the unpopular mix of available items are significant sources of consumer dissatisfaction, which contributes to low labor productivity. In the United States, items incorporating recent technological advances—digital watches, calculators, and video recorders—are widely available at low cost, but these are not generally available in the USSR. Soviet domestic production of many of these items started several years after commercial production began in the United States. 25X1
- The Soviet diet relies more on starchy staples and a larger proportion of Soviet daily protein intake comes from nonmeat sources. Shortcomings in processing and distribution often limit the variety of foods, especially fresh fruits and vegetables out of season. 25X1

Soviet performance in other areas is brighter:

- In terms of overall nutrition, the diet now nearly matches that of the United States. Although Soviet citizens on the average still eat only half as much meat as US citizens do, their per capita consumption of meat has increased by 40 percent since 1970.
- Soviet per capita expenditures for consumer durables are less than 20 percent of the US level—but they have nearly doubled since 1960. Almost every US family has a refrigerator and at least one television set; two-thirds of all Soviet families have refrigerators and nine-tenths have television sets. 25X1

Outlook

Despite some progress, the Soviet economy has a long way to go to catch the United States. Several Communist countries, particularly China, have in some sectors moved from centralized planning toward free markets, suggesting that the influence of the Soviet model for development has already weakened. The limited and largely experimental

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Central American Core Four: Struggle for Economic Recovery

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Although expanded US aid to the Core Four—Guatemala, Honduras, Costa Rica, and El Salvador—is providing a much-needed economic boost, few signs of internally generated strength have been exhibited as these countries struggle to emerge from their worst recession on record. Governments have been unable or unwilling to abandon counterproductive economic policies; world commodity markets have remained depressed; and political instability has discouraged investment. While the modest upturn begun in 1984 is likely to continue through 1986, growth will be too slow to prevent further declines in per capita income. The social pressures engendered by ongoing economic stagnation will compound the other problems confronting the region's emerging democracies.

The Dismal Economic Record

Insurgent activity and depressed markets for the region's agricultural exports have choked economic activity throughout Central America. After two decades of nearly uninterrupted growth that had provided a gradual improvement in average living standards, economic performance has been dismal since 1979.

As a result, the region is in the midst of its worst recession on record—per capita GDP has fallen nearly 20 percent from the 1979 peak. Domestic and international commerce have suffered dramatic setbacks that idled much of the labor force and industrial capacity. Foreign commercial lending is almost nonexistent, capital flight continues to drain domestic investment funds, and public investment programs have been slashed to trim budget deficits. Governments have not taken decisive actions, but instead have pursued policies to maintain consumption and public support. Regional security concerns continue to dampen business confidence. While higher US aid has been the catalyst for small GDP growth in 1984 and 1985, local economies have

showed virtually no sign of internally generated economic growth, and regional per capita income continues to decline.

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External Environment

There are few prospects for a recovery in the principal agricultural exports of the Core Four. International commodity experts forecast continued depressed prices for coffee, bananas, cotton, and sugar, which account for more than one-half of the region's export value. Prospects for the region's nonagricultural exports also are poor. Virtually all of the Core Four's manufactured goods are sold in the Central American Common Market, and continuing foreign payments problems are prompting member governments to maintain, or even strengthen, existing trade barriers. Moreover, producers cannot easily tap outside markets after being shielded from competition for 25 years by a protective common external tariff.

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Large debt service obligations underscore the urgency of developing new sources of export earnings. Official data show that the Core Four's external debt represents a higher share of GDP than Latin America as a whole. Even so, because a larger portion of the region's debt is owed to official sources, its ratio of debt service to exports is somewhat less than the Latin American average.

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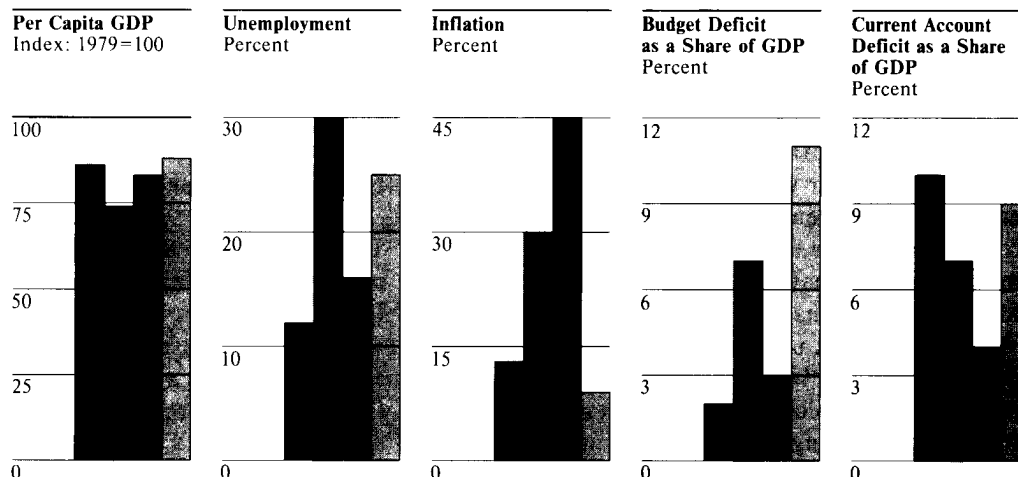
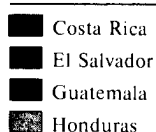
Reducing current annual debt service obligations of some \$1.5 billion by new rescheduling exercises will provide only minor relief unless creditors make major concessions. Moreover, the Core Four governments have been reluctant to satisfy conditions

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Secret**Cour Four Austerity Indicators, 1985^a**

Note scale change

^a All 1985 values are projections.

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for debt reschedulings. Honduras's debt negotiations were recently suspended because the government refused to undertake an IMF-supported adjustment program, according to Embassy reporting. El Salvador and Guatemala also made no attempt to obtain an IMF-supported program in 1985.

Core Four leaders are finding it increasingly difficult to adopt and sustain domestic economic measures needed to rebuild strong economies. Austerity programs are being implemented only on the margin to maintain fragile popular support for government, which has resulted in the loss of badly needed foreign investment, lending, and aid. More drastic measures are being thwarted by labor unions and consumer groups, seeking higher wages and consumer subsidies, most notably in El Salvador and Guatemala. Guatemala, Honduras, and Costa Rica all show signs of policy compromise to avoid public discontent before elections scheduled over the next few months.

Country Prospects for 1985 and 1986

According to our analysis, Core Four GDP will rise only about 1 percent in 1985, down from nearly 2-percent growth in 1984, primarily because of the poor performance of the Guatemalan economy—the largest in the region. For 1986 we see slightly better conditions facing the Core Four because new civilian presidents in Guatemala, Honduras, and Costa Rica probably will have some margin to implement needed economic adjustments. Even so, we expect serious and persistent trade, debt, and security problems to limit real GDP growth to only 1.5 percent. Because this modest GDP growth falls short of projected population increases, average living standards will continue to erode except in Costa Rica, where a slight gain is likely. Regional unemployment problems will persist and probably worsen as new job creation fails to match the demographics of the workforce.

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Core Four Debt Indicators, 1985

	Total External Debt ^a (billion US \$)	Debt-to-GDP Ratio (percent)	Debt Service (billion US \$)	Debt Service Ratio (percent)
Costa Rica	4.10	123	0.50	53
El Salvador	2.10	47	0.34	33
Guatemala	2.40	25	0.48	37
Honduras	2.40	74	0.20	30
Core Four	11.00	53	1.51	36
Latin America	380.00	48	56.00	41

^a As of midyear.

The **Guatemalan** Government has not implemented economic adjustments this year because of a lack of consensus among interest groups and a recognition by Chief of State Mejia that economic measures have immediate social costs that precede longer term improvements. As a result, we expect real GDP to fall 1 percent in 1985. Business and consumer confidence has been shaken by a 60-percent currency depreciation and an inflation rate of 45 percent. A poorly planned transition to a dual exchange rate system in late 1984 sharply reduced Central Bank foreign exchange receipts as exporters withheld funds from the official market. The quetzal depreciated rapidly as Guatemalans converted cash holdings to dollars because of the uncertainty over transferring power to a civilian president and negative rates of return on domestic savings from controlled interest rates. Production during the year was disrupted because the government was unable to make timely payments for fuel and other priority imports. []

Some improvement can be expected for 1986, but the new civilian government faces the need to implement long-delayed austerity measures. According to Embassy and press reporting, foreign

economic assistance is likely to increase somewhat, boosting depleted foreign reserves by the second half of 1986 and leading to a rebound of crucial imports. Aid donor pressures for economic reform will require the government to consider measures to stabilize exchange rates, raise taxes, and slow credit expansion. On balance, the best we see for the economy is a rebound during the second half of 1986, and overall GDP growth of 1 percent for the year []

Costa Rica's economic growth probably will slide in 1985 to about 3 percent, according to several independent forecasts—one-half last year's level but still the highest in the region. The lower growth is largely the result of reduced production for export and falling domestic demand. A major drop in banana output—as foreign producers abandoned their operations—has been a major factor. While Costa Rica's financial stabilization program has been the most successful in the region, at midyear San Jose temporarily fell out of compliance with its IMF program in large part because election politicking caused the National Assembly to block progress on trade and budget deficits. []

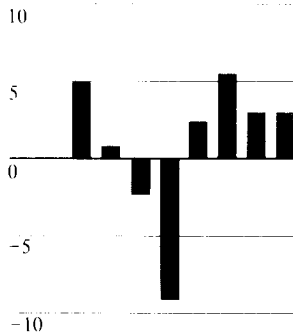
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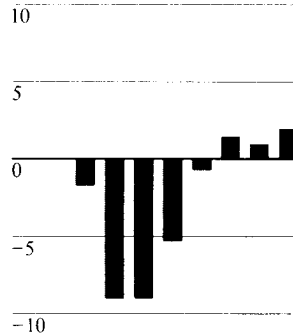
Core Four Real GDP Growth, 1979-86

Percent

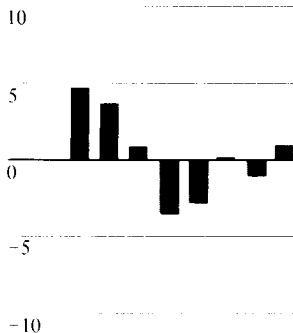
Costa Rica



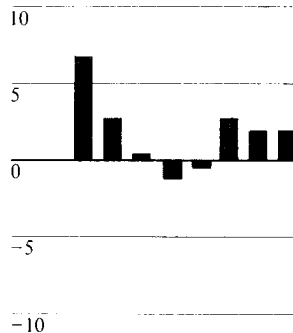
El Salvador



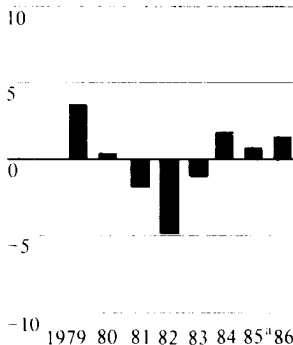
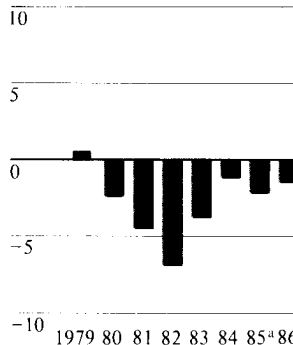
Guatemala



Honduras



Core Four

Core Four Real GDP
per Capita^a Projected.

Economic prospects for 1986 are no better. To regain access to foreign credits, San Jose has agreed to tougher austerity steps for next year, including spending cuts, new budget controls over state enterprises, and a wage freeze. The new president scheduled to take over next May will have to rely on continuing budget restraints to keep from defaulting on heavy debt obligations. Overall we agree with forecasters who see 3-percent economic growth as the best that San Jose can expect for next year.

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Although the *Salvadoran* Government and independent forecasters had been projecting 2- to-3 percent growth for 1985, recent Embassy reporting indicates that the final figure will be closer to 1 percent. The failure to build on the 1.5-percent growth of 1984—the first year of economic growth since 1979—is largely due to poor management of macroeconomic policy and private-sector distrust of the socialist orientation of the Christian Democratic Party. A gradual improvement in President Duarte's strained relations with the business community was quickly reversed in August, according to Embassy reporting, when the government failed to consult the private sector on a decree that limited profit margins for some industries. The foreign payments position continues to worsen, and inflation is up sharply this year—spurred by an acceleration of monetary growth and a rapid currency depreciation.

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The poor business climate and growing labor problems are likely to continue to constrain economic performance in 1986. Persistent insurgent attacks against economic targets also will take their toll. Furthermore, we see no sign that Duarte will reverse the current policy drift that has led to unprecedented inflation and a poor investment climate. The rising price level will complicate efforts to keep government spending under control. Duarte probably will have to accede to many of the workers' demands to prevent crippling strikes and work slowdowns. We believe these negative factors

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will be more than offset by US aid, however, enabling the economy to achieve 2-percent real growth next year.

For *Honduras*, most forecasters are projecting real growth of about 2 percent in 1985, although the government's midyear estimate put growth at over 3 percent. Both US Embassy and IMF officials believe the economy requires a strong set of stabilization measures, particularly an adjustment of the overvalued exchange rate. In the face of widespread opposition to devaluation, however, the government has opted to keep ailing export industries afloat by granting special tax incentives. The Suazo government also has been unwilling to limit spending or raise taxes to control the fiscal deficit, which we estimate will be 11 percent of GDP this year.

For 1986, sustained levels of US aid probably will be sufficient to support real GDP growth of 2 percent, but other economic indicators are likely to turn down. The expansionary fiscal and monetary policies of the last two years will begin to accelerate price increases. This will further encourage demands by public-sector workers for higher wages, requiring even greater domestic financing of the deficit. On the trade front, the international competitiveness of Honduran products will continue to suffer from the unrealistic exchange rate. We see little relief in sight since the leading presidential candidates have not addressed economic policy issues during the campaign, and are unlikely to make it a priority if elected.

Looking Ahead

For the longer term, we believe that sluggish economic growth for the Core Four will continue with regional growth likely to range between 2 and 5 percent. At the lower end, increased production would fail to match the region's 3-percent population growth, and average living standards would continue to fall. Even at the upper end of this range, anything less than 5-percent growth will be insufficient to create enough jobs to absorb the growing labor force.

The governments must sustain adequate security and favorable economic policies over the medium term if investors are to return to the area. Continuing economic troubles, however, are likely to undercut social and political progress in the region. Popular frustration may contribute to a revival of political instability, making the Core Four more vulnerable to inroads by political radicals or armed insurgents. Such pressures could lead to strains in US relations with Core Four governments as they demand ever higher levels of US assistance.

Even under favorable circumstances, our analysis indicates that it will take more than a decade to restore living standards to pre-1980 levels. In this situation, even with preferential trade and aid from the United States, we expect growing local criticism of close economic and political ties to the United States from the press, opposition politicians, and labor unions. On the plus side, we expect that even worse economic problems in Nicaragua will provide little incentive for radical political movements within the Core Four countries to point to Sandinista-style economic structures and institutions as a role model.

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Briefs

Energy

*OPEC Production
Update*

OPEC crude oil output in October averaged 17.5 million b/d, a 2.3-million-b/d increase from September levels. Saudi Arabia captured the lion's share of the seasonal demand upswing, with a 1.2 million b/d rise in production. New Iraqi pipeline access and Iranian repairs at its Khark Island tanker loading facility allowed both nations to boost output, and production also grew in Nigeria, Libya, and the UAE.

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OPEC: Crude Oil Production, 1985

Million b/d

	Quota	First Half	Third Quarter	September	October
Total	16.00	16.0	14.9	15.2	17.5
Algeria	0.66	0.7	0.7	0.7	0.7
Ecuador	0.18	0.3	0.3	0.3	0.3
Gabon	0.14	0.2	0.2	0.2	0.2
Indonesia	1.19	1.2	1.2	1.2	1.2
Iran	2.30	2.4	2.2	2.1	2.5
Iraq	1.20	1.3	1.4	1.4	1.7
Kuwait ^a	0.90	1.1	1.0	1.0	1.0
Less share of Neutral Zone		0.9	0.8	0.8	0.8
Libya	0.99	1.1	1.1	1.1	1.2
Nigeria	1.30	1.5	1.3	1.5	1.7
Qatar	0.28	0.3	0.3	0.3	0.3
Saudi Arabia ^a	4.35	3.4	2.7	2.8	4.0
Less share of Neutral Zone		3.2	2.5	2.6	3.8
United Arab Emirates	0.95	1.1	1.1	1.1	1.2
Venezuela	1.56	1.6	1.5	1.5	1.5

^a Neutral Zone has no production quota; output is divided between Saudi Arabia and Kuwait and included in their country quotas.

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*Kuwait To Import
Iraqi Gas*

Kuwait is expected to sign an agreement with Iraq to import 200 million cubic feet per day of natural gas by the end of the month, according to the US Embassy. Kuwait faces a gas shortage resulting from cuts in oil-associated gas production paralleling the nearly 60-percent cutback in oil production since

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1979 and a simultaneous increase in gas demand as new industrial plants have come on line. The Iraqi gas will be supplied through a new pipeline, planned for completion in about six months, stretching 90 kilometers from the Rumailah oilfield in southern Iraq to Kuwait's existing gas distribution system. The gas reportedly will be sold at only \$1 per million BTUs, worth approximately \$70 million per year. The Iraqi gas will be used as fuel for power stations, feedstock for the underutilized Shuaiba LPG plant, and feedstock for petrochemical plants. Kuwait will probably continue to seek gas from other sources including Qatar and the UAE.

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*Syrian Oil and Foreign
Exchange Shortages*

The unraveling of Syria's lucrative oil deal with Iran has forced Damascus to buy oil on the spot market at a time when its foreign exchange reserves are practically exhausted. According to the US Embassy

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Iranian oil shipments to Syria have been suspended for nearly two months, forcing Syria to slow refinery operations and to seek alternative supplies. As a result of its exchange shortage, Syria is falling even further behind than usual on payments to creditors, including Western banks. The Iranian arrangement has been troubled for over a year by Syria's inability to pay its oil debts. A cooling of the Iranian-Syrian friendship and Iran's own need for cash has also cut Iranian tolerance. If Iran does not resume shipments soon, Syria will be forced to turn to Saudi Arabia, Libya, or even Iraq for help in meeting its oil needs.

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*Prospects Dim for
Nova Scotian Gas
Exports*

Production from the Venture development—the main Nova Scotian offshore gas project—was supposed to begin in the early 1990s, with most of the gas allotted for export to the northeastern United States. Mobil, the lead partner, has had a string of five disappointing test wells, however, and was forced to admit that it has not found adequate reserves to fulfill its export contracts. Moreover, Ottawa's new energy policy is phasing out generous incentives for offshore exploration. The Nova Scotian Government and Ottawa are renegotiating the regulatory and fiscal regime applying to Venture, but, without a major discovery soon, it is doubtful any new inducements will be sufficient to restore activity to the boom levels of 1983. Further, the new federal energy policy, by switching the focus back to Western Canada, may permanently render commercial development of the offshore Nova Scotian projects unprofitable.

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*South Africa Plans
Major Synfuels Project*

In its latest move toward energy self-sufficiency, Pretoria announced last week plans to tap seabed natural gas reserves off South Africa's southern coast at Mossel Bay, and to build a plant to convert the gas into gasoline and other liquid fuels. The project will be capable of full production by 1991, according to government statements, and it will supply about 10 percent of the country's annual liquid fuel needs for 20 years. Because foreign banks are reluctant to offer credits, Pretoria intends to produce 70 percent of the project domestically and may sell shares to South African investors to pay for remaining imported materials. While Pretoria has long been committed to

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energy independence, the Mossel Bay synfuels project certainly was spurred by mounting foreign economic sanctions, as well as soaring costs for imported fuel because of the sharp decline of the rand.

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*✓ France Cuts
✓ South African Coal
Contracts*

Paris has announced that contracts for 3.9 million metric tons of coal—about 80 percent of French coal imports from South Africa—will not be renewed when they expire at the end of this year. In 1984 South Africa provided 23 percent of French coal imports. France is not expected to seek replacement coal imports because coal consumption continues to decline as nuclear use grows. While characterized as a step against apartheid, Paris's action is in reality an economic response to its coal situation.

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International Finance

*✓ Polish Financial
Problems Continue*

Warsaw admitted to government creditors last week that it cannot cover all payments due to banks and governments in the next two months—the first formal admission that the Poles cannot honor rescheduling agreements. The Poles are deciding whether to pay the \$220 million in interest due to the Paris Club governments in November or the \$240 million in principal owed banks in December. Warsaw also says it cannot cover the \$550 million in interest due at the end of the year on official debt due for 1982-84, as rescheduled in July. Poland met with the Paris Club this week to sign a rescheduling agreement for debt due in 1985, and it is requesting another meeting next month to discuss payment problems anticipated for 1986. The decision to approach the Paris Club for relief suggests Poland will continue to give more favorable treatment to banks. The Poles know the governments have little leverage because they tolerated more than \$10 billion in arrears in 1982-84. Poland is likely to have even greater difficulty next year, when the gap between resources and debts due is expected to widen to more than \$1 billion.

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*✓ Resumption of
Philippine IMF
Program Likely*

According to US Embassy reporting, Manila and the IMF have reached informal agreement on several issues—including the budget deficit, exchange rate policy, and reforms in agricultural marketing institutions—breaking a two-month deadlock and paving the way for a \$212 million disbursement from the Fund's \$615 million balance-of-payments loan. The IMF and World Bank are accepting Manila's largely superficial reforms in the sugar and coconut industries and the Fund is setting relatively expansionary targets for the budget deficit and money supply. Agreement on these issues by the IMF's Executive Directors in mid-December would set the stage for the release of \$525 million in new loans from Manila's commercial creditors. Over the next few months, however, compliance with the Fund's program could be jeopardized by a surge in government spending tied to the snap presidential election early next year—some opposition politicians believe Marcos might pump up the money supply by as much as 60 percent. Even if such spending is modest

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and financed largely from within the current budget, Manila will be hard pressed during an election period to stay within its monetary and fiscal targets.

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*Mild French Reaction
to US Mixed Credits
Move*

Paris has reacted mildly to last week's US announcement to use subsidized, or mixed, export credits to compete with generous French mixed credits to developing countries. Paris reportedly wants to play down the recent US moves largely out of fear that deteriorating bilateral trade relations will cost access to the US market. [REDACTED] Paris's primary concern is penetrating the US market, a goal that was given a boost by the recent US decision to purchase a \$4.3 billion French military communications system.

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*London Expands
Export Credit
Program*

London recently announced a new soft loan program to help British exporters win major project bids in developing countries. The government will provide grants to banks to enable them to make below-market rate, long-term loans for LDC projects undertaken by British companies. The Overseas Development Administration will increase its Aid and Trade Provision budget by 25 percent over the next three years, with the goal of doubling British sales through the program. London has already held discussions with Beijing for a 20-year, \$140 million loan at a 5-percent rate of interest for the construction of power plants and machinery. The Thatcher government remains dubious about direct export assistance but is eager to capture new markets—especially in the Far East and Latin America—by matching the increased use of mixed credits by the French and the Japanese.

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22 November 1985

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✓ *Financial Crisis
Brewing in Senegal*

Dakar is seeking immediate Western financial assistance to save its IMF agreement. The US Embassy reports that a tax shortfall and low export prices have caused Senegal to delay debt payments in violation of IMF guidelines. To be in compliance again, the Fund recommends that Dakar cut spending and increase taxes immediately and assumes it will receive \$20 million in US aid before the end of the year. President Diouf also will request emergency funds from France during his visit there later this month, according to the US Embassy. Dakar probably will obtain enough temporary financing to avoid the immediate suspension of its IMF program. Remaining solvent through 1986 will prove difficult because neither France nor Arab donors are likely to provide significantly higher levels of assistance. Another round of government layoffs and consumer price hikes will add to Diouf's serious political problems.

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✓ *New Zealand Accepts
Foreign Banks*

Completing a far-reaching liberalization of the financial industry, Wellington now is proposing to treat foreign and domestically owned banks equally, to ease substantially capital and liquidity regulations, and to allow nonbanks to provide financial services. Finance Minister Douglas has argued that the country's restrictive banking environment is hindering its economic restructuring away from a heavy dependence on dairy and sheep products. Douglas is warning, however, that bank managers and depositors will bear the risk of all transactions because the government will not be offering deposit insurance. For their part, New Zealand bankers have long known Douglas's intentions and are geared up for deregulation at a time when interest rates are extraordinarily high. We expect fierce competition in the year ahead to produce a few bank failures and mergers, but Wellington's moves are likely to produce a far more efficient financial sector.

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Global and Regional Developments

✓ *Canada Reassuring
Tokyo on Trade*

_____ Ottawa is courting Japanese investment in Canada by assuring Tokyo that, under a free trade pact between Canada and the United States, Japanese-owned plants probably would be guaranteed access to US markets equal to that granted Canadian firms. Such assurances have already been offered regarding the US-Canadian Auto Pact. This attempt to attract Japanese investment is aimed at stimulating employment in Canada and quelling Japanese criticism of the proposed US-Canadian pact. Ottawa is likely to make similar offers to others and assure them that their interests will not be damaged by an economically stronger North America.

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✓ *Mitterrand To Attend
Tokyo Economic
Summit*

President Mitterrand repeated to the US Ambassador last week his familiar litany of complaints about the economic summits but confirmed that he had accepted Prime Minister Nakasone's invitation to attend next year's Tokyo meeting. Mitterrand said that the summits had become too stiff and formalized, no longer providing a forum for frank, off-the-record exchanges among

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leaders. He objected especially to the increasing use of summits to discuss political and strategic issues and underscored France's unwillingness to address terrorism at the summits. On a related issue, Mitterrand expressed French willingness to enter into a new GATT round but warned that he could change his mind if he felt that agriculture was being singled out as the target of the negotiations. He suggested instead that one of the major goals of the new round should be prying open Japanese markets. []

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✓
*Japanese Position
on Economic Aid
to Vietnam*

The US Embassy reports Japan has no intention of resuming economic aid to Hanoi until Vietnamese troops leave Cambodia. The issue of aid, which surfaces periodically in Tokyo, was raised again in a Japanese Southeast Asian chiefs-of-mission conference this fall in Hong Kong. A Japanese consular official in Hong Kong, who favors aid to Vietnam, claimed the subject will soon be taken up by the Foreign Ministry. Some Japanese firms—which would like to do business with the Soviet-Vietnamese oil exploration venture in the South China Sea—have also pressed the Foreign Ministry from time to time to change its stance. Nonetheless, we believe Tokyo's strong support for ASEAN's position on Cambodia will uphold its prohibition on economic aid to Hanoi for now. Any weakening of ASEAN's commitment, however, may renew the debate. []

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✓
Gandhi Visits Japan

Prime Minister Gandhi will go to Japan next week seeking to expand economic cooperation between the two countries. The Indians have already pressed the Japanese for a large low-interest loan, in addition to almost \$200 million already earmarked by Tokyo this year. Gandhi also would like to draw the Japanese into further competition with the United States and Western Europe for high-technology sales to India. The Japanese are anxious to make the visit a success because his economic liberalization program could open the large Indian market to more Japanese goods. They are most interested in selling middle-level technology and have told US officials that they are concerned that advanced technology sold to India could be diverted to the Soviets. Tokyo is considering suggesting a memorandum-of-understanding on technology transfer with India similar to the US-Indian agreement. Gandhi and Prime Minister Nakasone are likely to sign a science and technology agreement that will focus on cooperation and exchange programs. []

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✓
*Beijing Asks Japan To
Increase Grain Imports*

[] a high-level Chinese delegation that left Japan this week pressed for a fivefold increase in Japan's purchases of Chinese grain by 1990—including a contract for \$100 million in additional grain purchases over the next year—but probably achieved little success in expanding Japanese commitments. Chinese press reports indicate a grain agreement was signed, but no figures were reported. We believe Japanese imports of Chinese grain over the next several years will fall far short of Beijing's stated goals. Nonetheless, Japanese importers—largely the major trading companies—will probably increase grain imports somewhat to reduce Chinese criticism of Japan's growing bilateral trade surplus and to decrease the

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resulting threat to their exports to China. Such imports would probably come at the expense of US grain exports to Japan, but Tokyo will probably attempt to avoid taking a stance in order not to worsen trade friction with either the United States or China.

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*✓
Malaysian State
Visit to China ✓*

Prime Minister Mahathir, accompanied by Foreign Affairs Minister Rithauddeen and a trade delegation, pays his first state visit to China 20-28 November, to meet with Premier Zhao Ziyang and discuss strengthening trade links. economic discussions will be limited to noncontroversial matters, such as an agreement on double taxation. Mahathir undoubtedly expects the trip to enhance his appeal to ethnic Chinese voters in general elections expected next spring, but it also underscores Kuala Lumpur's new policy of pursuing a more practical economic relationship with Beijing. Since 1984, Malaysia has relaxed restrictions on business travel to China and is now considering formal agreements on direct trade, shipping, and investment. Malaysia sees China as an increasingly important market for its major commodities, such as palm oil and rubber, and possibly for its new automobile, the Proton Saga, which was first marketed earlier this year.

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*✓
Possible Barter of
Soviet Machinery for
Bolivian Tin ✓*

Soviet Embassy officials in Bolivia have publicly expressed interest in bartering Soviet machinery for Bolivian tin. Moscow imports roughly one-third of its domestic tin requirements and, over the past several years, has had a long-term supply agreement with Bolivia. While most Bolivian tin sales to the USSR are reportedly for hard currency, we believe the USSR is pursuing a barter arrangement in view of its emerging hard currency stringency and as part of its overall efforts to expand machinery exports. Moscow may also be taking advantage of the collapse of the international tin market—Bolivia depends on tin sales for roughly one-third of its export earnings. Although Bolivian experience with Soviet machinery has generally been poor, La Paz reportedly may favor a barter agreement because of the drop in tin prices.

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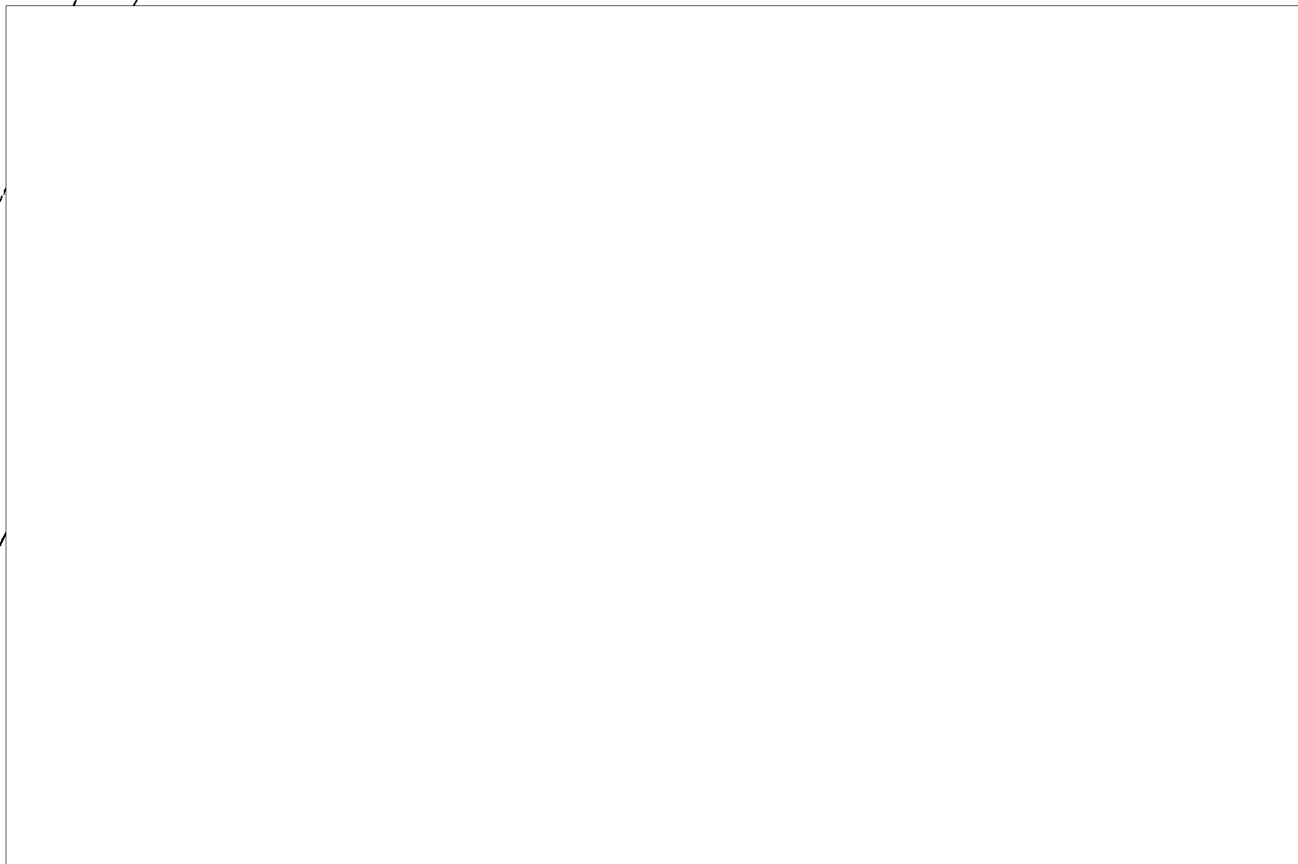
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National Developments

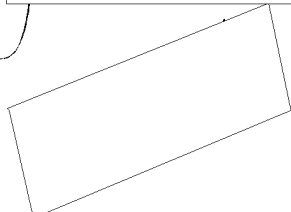
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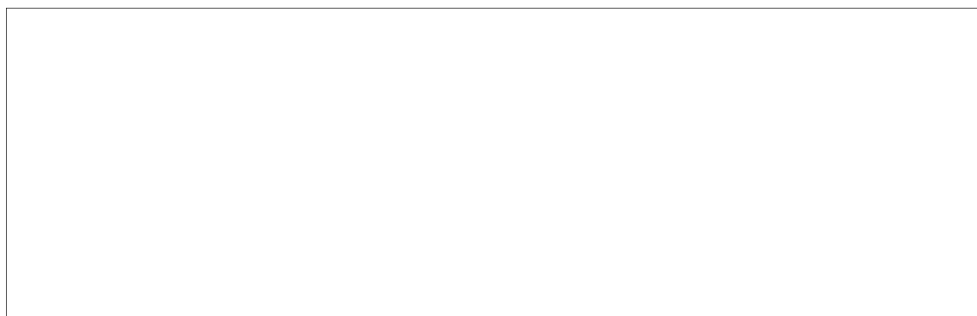
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*Thatcher Blamed for
Britain's "Dismal"
Economic Future*

A House of Lords committee report blames the Thatcher government for the decline in the UK manufacturing base and export potential and predicts a future of chronic balance-of-payments crises, economic stagnation, and higher inflation. The study looks at future economic development once North Sea production falls off, and the oil trade surplus disappears—as early as 1990 by

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some estimates. It argues that services will not be able to replace jobs and exports lost by the decline in traditional industries. The report severely criticizes the government's laissez-faire approach and urges it to promote innovation, improve product quality, stabilize exchange rates, and enforce realistic wage settlements. Government officials sharply rejected the committee's findings, stressing that the British economy is healthier than when the Tories took office in 1979, and that the economy has 15 to 20 years to adjust to the decline in oil output. The report is probably overly pessimistic, particularly about the potential of service industries.

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*Britain Offers Some
Fiscal Expansion*

London's autumn economic statement, delivered last week, provides some relaxation of fiscal policy and preserves the possibility of tax cuts in next year's budget. Chancellor of the Exchequer Lawson stressed increased spending on public programs rather than the need for fiscal restraint. London expects to obtain some \$20 billion from the privatization of several nationalized industries over the next three years, and will use these funds to increase spending for public projects, such as housing renovation and roads, and for health, social security, and employment programs. While Lawson did not announce how large a tax cut is planned, financial analysts forecast a reduction of \$2.8-3.5 billion. Nevertheless, government spending as a share of GDP will fall 1.5 percentage points in 1986—to about 43 percent—following a similar decline this year, reflecting Thatcher's goal of reducing the role of the government in the economy.

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*Proposed Sale of
British Gas Corporation
Scrutinized*

Chancellor of the Exchequer Lawson recently announced plans to sell British Gas Corporation as a single entity, beginning in the autumn of 1986. Critics believe that the decision was premature because crucial questions remain concerning the proper valuation and appropriate regulatory mechanism needed when the monopoly is no longer state owned. Britain's small independent oil companies, for example, fear competition from British Gas if it expands into oil exploration. Others—who would prefer to see the gas company split into three or more separate parts—criticize the government for not giving enough thought to Britain's future energy needs, including a depletion policy for North Sea oil and gas. Meanwhile, financial analysts believe that the sale—the largest privatization project to date—will prove difficult because of the size of the offer—estimated at \$7-10 billion over a three-year period—and the fact that it is not a high-technology stock with rapid growth potential. Prolonged delay in selling off the company could jeopardize London's plans to deliver sizable tax cuts before the election to be held by the spring of 1988.

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*France To Tighten
Monetary Policy*

To reduce inflation further, Finance Minister Berezogovoy has announced that France will trim its target range for monetary growth in 1986 to 3 to 5 percent from 4 to 6 percent, continuing a policy of gradual reduction followed by the Socialists since 1982. He also announced that France will target a broader monetary aggregate (M3R), which includes deposits and nonnegotiable short-

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term assets at all institutions, rather than the old target (M2R), which only included bank deposits. This switch to the new aggregate is an effort to treat all liquid assets equally and is intended as a step toward further reform of France's financial system. Credit rationing will remain the prime instrument of control next year but could be phased out in the latter part of the year as France moves toward modernizing domestic financial markets and replacing credit controls with a reserve-based system.

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West German Subsidies on the Rise

Two recent studies indicate that Chancellor Kohl has failed to fulfill his campaign promise to slash government subsidies to open markets and encourage restructuring, according to the US Embassy. A government white paper admits that total grants and tax preferences rose more than 20 percent from 1982 to 1985—when they reached \$27 billion—but attributes the rise chiefly to automatic indexing. The independent Kiel Institute, using a more comprehensive definition, calculates that subsidies rose to \$42 billion over the same period. Kiel estimates that a 50-percent reduction in subsidy payments, passed on in the form of general tax cuts, would eventually generate enough economic growth to absorb nearly half the nation's 2.3 million unemployed. Both studies indicate that the coal and farm sectors are major recipients. Kohl is unlikely to develop a comprehensive program to cut subsidies before the early 1987 parliamentary elections. None of the coalition parties is enthusiastic, and Kohl does not wish to antagonize the farm lobby or risk being blamed for the closure of inefficient firms.

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Italian Budget Negotiations Resume

The recently reinstated Italian Government reopened parliamentary debate on the 1986 budget this week. The government's budget calls for reducing the deficit to \$58.4 billion—equivalent to 14.6 percent of GDP, down from an estimated 15.6 percent this year. Opposition to the government's budget proposal—which cuts public spending on health, education, and pensions—comes primarily from the powerful labor unions and the Communist Party, but even some members of the coalition have denounced the bill. Achieving an acceptable budget package, without bringing already high interparty tensions to the breaking point, will tax Prime Minister Craxi's leadership abilities to the full. Compromises will be necessary, further enfeebling the government's already meek austerity efforts. The public-sector deficit is more likely to surpass 16 percent of GDP next year, particularly if, as is probable, the 31 December deadline is missed, continuing this year's spending levels into 1986 while parliament meets in special session.

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Mexico's Economic Challenge

The economic program for next year that President de la Madrid outlined last Friday in his annual budget message allows for little or no growth, tries to cut the share of the deficit in GDP by half, and proposes to reduce inflation from 60 percent to 45 percent. De la Madrid is also promising significant economic

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restructuring and reaffirms the government's intention to honor its debt obligations. Although de la Madrid knows what corrective policies are needed to rescue the economy, he probably lacks the political mettle to follow through on his initiatives. Disputes within his economic cabinet threaten to undermine the confidence he is trying to build to gain popular support, stem capital flight, and temper inflationary expectations. Demands that the government abandon austerity are sure to grow. []

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Indo-Pakistani Trade Initiative

Last week, high-level Pakistani and Indian economic officials agreed to start detailed negotiations to increase trade and cultural exchanges. Islamabad took the initiative and proposed that both countries renew private-sector trade—suspended by Pakistan in 1978—establish joint ventures, review taxation policies, and enhance communication through student exchanges, improved telecommunications, and a new regional airline. Indo-Pakistani trade peaked near \$100 million in FY 1981 (July/June) and has since dropped to an estimated \$50 million in FY 1986, accounting for less than 1 percent of each country's annual foreign trade. Trade opportunities do exist for certain manufactures and commodities, but Pakistani fears of Indian dumping, bureaucratic resistance, and foreign exchange shortages may well inhibit any rapid increase. New Delhi has so far been noncommittal, but Islamabad's efforts to increase trade can provide an opportunity to improve bilateral relations. []

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High Prices Spur Pakistani Opium Production

High prices, good rains, and indifference by local politicians are likely to lead to an increased opium crop in Pakistan this year, [] The price of dry poppy has doubled this fall, to over \$120 per kilogram, and farmers have expanded acreage in most areas of the Northwest Frontier Province, Pakistan's major opium-growing region. Despite claims by Islamabad that it is cracking down on poppy cultivation, [] a "relaxed" attitude on the part of police and tacit support of growers by some local political leaders. The proposed lifting of martial law in January is likely to enhance the power of uncooperative local leaders, and a large spring crop will further complicate national drug enforcement efforts. []

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South Korea's Economy Finally Turns Up

South Korea has reversed five successive quarters of declining real GNP growth by posting a 5.4-percent gain in the third quarter compared to the same quarter last year; growth had fallen from 12.6 percent in the fourth quarter of 1984 to 2.7 percent in the second quarter of this year. The upturn reflects the effects of Seoul's pump-priming package—the social-welfare sector grew by 8 percent—and an almost 9-percent real increase in agriculture. In addition, exports of manufactured goods surged 8.8 percent in the third quarter. Seoul continues to publicly cling to its 5 to 6 percent forecast of real GNP growth for this year, but government economists have told the US Embassy growth is unlikely to exceed 4.5 percent. We believe the 6-percent fourth-quarter growth

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required to meet even this lower target will challenge Seoul, as the rice crop will not match last year's bumper harvest and the export scene remains uncertain.

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*Malaysian Oil
Company
in Good Financial
Health*

Malaysia's national oil company, Petronas, this week announced a 31-percent increase in earnings to \$2.2 billion for fiscal year 1984/85, largely resulting from a doubling of LNG exports. The chairman said that earnings figures—closely held in the past—were being released to allay public concern over its financial soundness following last year's bailout of government-owned Bank Bumiputra and the \$100 million purchase of a Boeing 747 for the national airline earlier this year. The US Embassy suspects the announcement is aimed more at reassuring the public that the government has the resources to support Bank Bumiputra if the international tin market should collapse, forcing the International Tin Council to default on the estimated \$100-150 million it owes to the Bank.

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*China Seeking
Truck Technology*

Communist

In the first such technology exchange, an automobile plant in northwestern Hubei Province has purchased technology for design and manufacture of 8-ton trucks from Nissan Motor Company. The sale may be a concession, aimed at easing Chinese resentment of Japan's continued refusal to transfer automotive production technology while accounting for approximately 98 percent of China's automobile-related imports since 1973. China is also negotiating with a large US manufacturer for the construction of a \$1 billion truck production plant near the same facility. However, infusions of technology and equipment are unlikely to greatly increase output at the plant because of sustained power shortages and problems with material flows.

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